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IN THE

Supreme Court of the United States

OCTOBER TERM OF 1959

NO. 908

THOMAS McCAFFREY, JR. and LILLIAN S. McCAFFREY, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court is officially reported at 31 T.C. 505. The opinion of the Court of Appeals (Appendix A) is reported at 275 F. (2d) 27.

JURISDICTION

The judgment of the Court of Appeals was entered on February 10, 1960. (Appendix A, infra, p. 26 to 38 inclusive) The jurisidiction of this Court is invoked under 28 U.S.C. Section 1254.

QUESTION

Whether the Court of Appeals for the Third Circuit erred in holding that no similarity of "use" existed where an investor owning industrial real estate "used" by him only for securing rental income had his property taken from him by condemnation and who reinvested the proceeds of the condemnation award in other industrial real estate which was also "used" by the investor only for securing rental income.

STATUTE AND REGULATIONS INVOLVED

The statutory provision involved is Section 112(f) of the Internal Revenue Code of 1939, 26 U.S.C. Paragraph 112(f). It is printed in Appendix D, infra, page 58. The Regulations involved are Treasury Regulations 118, Section 39.112(f)-1, 1939 Code Fed. Regs. 118. They are printed in Appendix D, infra, page 59.

STATEMENT OF THE CASE

A. The Nature of the Proceeding

This case involves an income tax deficiency of approximately $11,000.00 for the calendar year 1953.

During the taxable year in question Petitioner, Thomas McCaffrey, Jr. [1] engaged in the business of an industrial realtor. In 1952 the Commonwealth of Pennsylvania condemned the Petitioner's co-owner's interest in real property located in the City of Pittsburgh, Pennsylvania. The Commonwealth of Pennsylvania paid to

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1. Petitioner and his wife filed a joint return. When "Petitioner" is referred to herein, such term also includes Petitioner's Wife.

the Petitioner the sum of approximately $57,000.00 as proceeds of such condemnation. Such sum being an excess of approximately $42,000.00 over Petitioner's cost for his co-owner's interest in the real estate. Following the condemnation, the Petitioner reinvested all the proceeds of the condemnation[2] in real estate located in New Castle, Pennsylvania.

Petitioner in his income tax return, filed for the calendar year 1953, claimed that the gain which he realized in connection with the taking of his Pittsburgh property was not includable in his income tax return for 1953 as taxable income by reason of the provisions of Section 112(f) of the Internal Revenue Code of 1939, which provided for the non-recognition of gain derived from property taken in condemnation where the proceeds of the condemned property were reinvested in other property similar or related in service or use to the property converted.

On the audit of Petitioner's income tax return, the Commissioner of Internal Revenue took the position that the Petitioner had not reinvested the proceeds of the condemnation award in property similar or related in service or use to the property condemned stating inter alia "since . . . proceeds from conversion was from *unimproved* real estate reinvested in *improved* real estate . . ." (Emphasis ours)

The Petitioner filed a Retition in the Tax Court of the United States contesting the determination of the

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2. Petitioner's reinvestment took the form of the acquisition of all the stock of Arsenal Corporation whose sole asset was the New Castle property. Reinvestment in that manner is approved in Section 112(f)(3)(A).

Commissioner of Internal Revenue. Upon hearing, the Tax Court of the United States entered judgment for the Commissioner of Internal Revenue, holding that the Petitioner had not reinvested the proceeds of the condemned property in property similar or related in service or use to the property condemned.

B. Facts

The facts of this case as found by the Tax Court may be restated as follows:

Thomas McCaffrey, Jr., of Pittsburgh, Pa., engaged in the business of an industrial realtor and appraiser since 1923.

In 1947, and at a cost of $15,000, the petitioner acquired an interest as one of two co-owners in certain real property located at 556-562 Second Avenue in the First Ward of Pittsburgh, Pennsylvania, and sometimes hereinafter referred to as the Pittsburgh property.

In 1923 and for an undisclosed period thereafter prior to 1947 the Pittsburgh property was used as a coal yard under a lease arrangement with the owners of an adjacent property. The neighboring properties were industrial in nature. The Pittsburgh property in 1923 was rectangular in shape with dimensions of 80 feet by 180 feet fronting on Second Avenue and was served by a railroad siding of the Pennsylvania Railroad and had no buildings on it.

When the petitioner acquired his interest in the property in 1947, the dimensions of the property were the same as stated above. The property had been filled, graded and blacktopped. Other than the grade that accommodated the leveling, the property was level with

the street. The railroad siding still served the property. The property also was served by the usual utilities—water, gas, electricity and telephone. There was on the property a small frame building which was adaptable for use only in the operation of a parking lot. Even though there had been some changes in ownership since 1923, the neighboring properties continued to remain substantially industrial in nature.

At the time the petitioner acquired his interest in the Pittsburgh property in 1947, Buford B. Epstein owned a property adjacent to and approximately of the same area as the Pittsburgh property. At that time Epstein, using his own property and the Pittsburgh property on which he held a lease, was engaged in the business of conducting a parking lot operation thereon. Throughout the entire period the petitioner owned an interest in the Pittsburgh property the property was leased to Epstein who continued to use it and his own property in the conduct of his parking lot operation. The leases from the petitioner and his co-owner to Epstein ran for a period of one year, provided that the property should be used only for parking purposes and contained a "sales clause" under which the owners in the event of the sale of the property could cancel the lease effective as of the first day of any month by giving Epstein 30 days' previous notice.

In 1952 the Commonwealth of Pennsylvania condemned the Pittsburgh property and in 1953 paid in condemnation to the petitioner for his interest therein the sum of $57,477.27. The excess of the condemnation proceeds over the cost to the petitioner for his interest in the property was $42,477.27.

After the petitioner received notice of the condemnation of the Pittsburgh property he investigated the possibility of obtaining within the downtown limits of Pittsburgh an industrial property of similar size but was unable to find any "to accommodate my [his] desires." The petitioner then made an investigation in other cities and other counties. He found available in the City of New Castle, Pennsylvania, which is in Western Pennsylvania and about 50 miles distant from Pittsburgh, a 9⅓ acre tract of industrially zoned real estate situated on Industrial Street in New Castle, then owned by American Can Company and sometimes hereinafter referred to as the New Castle property. On the tract was a building[3] two stories in height of brick and wood construction with concrete and wood floors, equipped with elevators, sprinkler system and heating system, and of over-all dimensions of 694 feet by 80 feet. Also on the tract were an engine room, garages and lumber shed. The New Castle property was situated in an industrial neighborhood, was served by two Baltimore & Ohio Railroad sidings and had all necessary utilities available. An undisclosed portion of the tract was surfaced with black top and cinder and was used for parking purposes by executives, employees and customers of a corporation conducting business on an adjacent tract. Another portion of the New Castle property had cinder surfacing for use in parking incidental to loading shipments by rail. American Can Company had been offering the New Castle property for sale since 1951 and the buildings were vacant and not in a tenantable condition.

When the petitioner learned of the availability of

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3. Sometimes referred to in the record as one building and sometimes as buildings Nos. 1 and 2.

the New Castle property, he also learned that the Federal Civil Defense Administration, sometimes hereinafter referred to as Civil Defense, had previously considered leasing the property but had declined to lease it because of the physical condition of the buildings. Thereupon the petitioner went to Washington, D. C., and began negotiations with Civil Defense for the latter to lease the property for use in storing about 20 million dollars worth of materials. After obtaining a commitment from Civil Defense to lease the property provided certain repairs, alterations and improvements were made, the petitioner negotiated the purchase of the property by Arsenal Corporation, a Pennsylvania corporation, from American Can Company, at a price of $155,000 of which $105,000 was represented by a mortgage on the property to American Can Company.

On August 14, 1953, and at a cost of $64,029.45, the petitioner purchased all of the issued and outstanding shares of the capital stock of Arsenal Corporation. At that time, Arsenal's assets consisted of the New Castle property as heretofore described.

During 1953, Arsenal Corporation leased the New Castle property to Civil Defense on a year-to-year basis for use for warehouse purposes and thereafter expended approximately $100,000 in making the repairs, alterations and improvements to the property required by the lease. Civil Defense required that the property be fenced and such use as was made of the property for parking purposes was only that which was incidental to Civil Defense's occupancy of the property. In fixing the rent paid by Civil Defense for the property, the petitioner did not include any amount as a charge for the use of the property for parking purposes.

In determining the deficiency in question the respondent determined that the petitioner was not entitled to the benefits of the nonrecognition of gain provisions of section 112(f) of the 1939 Code and determined that the gain of $42,477.27 realized from the condemnation of petitioner's interest in the Pittsburgh property constituted long-term capital gain taxable to the petitioner for 1953.

C. Decisions of the Courts Below

On the basis of the foregoing facts, the Tax Court held that the Petitioner was not entitled to the benefits of the nonrecognition of gain provisions of Section 112 (f) of the 1939 Code, and determined that the Petitioner had realized gain in the amount of approximately $42,000.00 from the condemnation of his Pittsburgh property and that such gain constituted long term capital gain. The Tax Court based its decision upon the following grounds:

(1) The test applicable in determining whether properties are "similar or related in service or use" is a "functional" test.

(2) Replacement of one industrial property with another or the replacement of one rental property with another does not satisfy the statutory test of "similar or related in service or use".

(3) The Tax Court relied principally on two cases, *Steuart Brothers, Inc.*, 29 T.C. 372, and *Lynchburg National Bank and Trust Co. v. Commissioner*, (CA-4) 208 F. (2d) 757, affirming 2[illegible] T.C. 670. The Tax Court interpreted those cases as holding that the statutory test is not satis-

fied by a replacement of one industrial property with another or by replacement of one rental property with another rental property, because in such replacements the functions of the old and the new properties would not necessarily be similar or related in service or use.

The Petitioner appealed from the Tax Court's decision. In affirming the judgment of the Tax Court the Court of Appeals for the Third Circuit adopted the grounds relied upon by the Tax Court, holding:

(1) That the nonrecognition of gain provisions of Section 112(f) are not available to the taxpayer simply because both properties were used by the taxpayer for the same "use"—i.e. the production of rental income; and,

(2) That the two properties were not "industrial" and thus not "similar or related in service or use" within the meaning of the statute; and,

(3) The fact that the taxpayer "used" the money invested in the old and new properties for the similar purpose of producing rental income does not bring into play the non-recognition of gain provisions of Section 112(f); and,

(4) That Section 112(f) is not concerned with "why" taxpayer invests the proceeds of the converted property but only "how" he does so; and,

(5) That the Pittsburgh parking lot property was not "industrial" but the New Castle property was "industrial"; and,

(6) That the Pittsburgh property and the New Castle property were not "similar" properties, physically; and,

(7) That no different standards are to be applied because of the status of the owners of the properties—i.e. "investors" v. "users"—in determining whether the replacement property is similar or related in service or use to the property so converted.

D. Petitioner's Position

No case involving the meaning of the language contained in Section 112(f) relating to the meaning of "conversion into similar property" and "into property similar or related in service or use to the property so converted" has yet been decided by this Court.

It is the Petitioner's position that:

(1) The "use" to which the taxpayer puts his money for the production of rental income in the two properties involved rather than the "service or use" which the properties were designed to afford to the tenants, or their physical characteristics, is dispositive; and,

(2) The two properties were, in fact, similar in that they are both "industrial properties" (Although the Court did not so find, the testimony clearly supports such conclusion.); and,

(3) The nature of the taxpayer's business has been the controlling factor in determining whether the replacement requisites of the statute have been met.

(4) The statute is not selective as to the various types of businesses which may have relief thereunder, but is equally applicable to all types of business.

(5) Congress did not intend such a narrow construction of the statute, and would have so stated if it had meant to exclude a taxpayer in a similar situation to the Petitioner.

(6) Petitioner should not be denied the relief granted by the statute because it does not replace the properties condemned with new properties which are physically similar and which are put to the same use as used by its lessees.

(7) The "functional" test must relate to the taxpayer's business and not to the physical aspect of the properties or the use made thereof by a person other than the taxpayer.

(8) Exact duplication of the converted property is not required.

(9) In the Statute the word "similar" is followed immediately by the phrase "or related", which considerably broadens the scope of the statute and gives the taxpayer more latitude in making an investment.

(10) The term "related" is followed immediately by alternative tests, that is, "in service" *or "use"*, and that the taxpayer, to secure relief, can meet either the test of "service" or "use" or either of them.

(11) The business of the taxpayer is the controlling factor in any determination as to whether the

acquired property is "similar" or related in service or "use" to the converted property.

(12) The function and purpose of the old and new properties must be approached from the taxpayer's perspective and not from the perspective of someone other than the taxpayer, to-wit, the taxpayer's tenant.

(13) The perspective of the taxpayer cannot be determined without taking into consideration the business of the taxpayer.

(14) A taxpayer who leases industrial property used by his tenant as a parking lot and a taxpayer who leases his property to a tenant who uses it as a warehouse is still in the realty investment business.

(15) Denial to the taxpayer of the relief provided in Section 112(f) would defeat the fundamental purpose of the non-recognition treatment on involuntary conversions and the Congressional intent in enacting such provisions.

(16) Congress intended the involuntary conversion sections to be relief sections and to be construed most strongly against the Government and in favor of the taxpayer.

REASONS FOR GRANTING THE WRIT

I. The Decision of the Court of Appeals Below Is Squarely in Conflict With the Decisions of the Courts of Appeal for the Fourth and Second Circuits.

The Court of Appeals for the Third Circuit relied principally upon the following grounds:

(1) That the non-recognition of gain provisions of Section 112(f) are not available to the taxpayer because both properties were used by the taxpayer for the same "use"—the production of rental income; and,

(2) That the two properties were not both "industrial"; and,

(3) The physical characteristics of the two properties were not similar; and,

(4) That the "service or use" which the two properties were designed to afford were dissimilar, since the old property was used as a parking lot and the new property as a warehouse.

The Court of Appeals for the Third Circuit is in direct conflict with the decision of the Court of Appeals for the Fourth Circuit, for the latter Court in *Steuart Brothers, Inc., v. Commissioner of Internal Revenue,* 261 F. (2d) 580, Appendix B pages 38 to 47 inclusive held that the taxpayer was entitled to the benefit of the statute because the original real estate was held by it for investment purposes and the proceeds of the condemnation were reinvested in real estate of the same general class, which was also rented.

The Circuit Court of Appeals for the Second Circuit, in an opinion written by Judge Learned Hand, in affirming the Tax Court's decision to the effect that the

mortgages purchased by the taxpayer with condemnation award money were not similar property, where the taxpayer had also reinvested part of the award money in other rental real estate, (the rental real estate reinvestment met the statutory test) stated (at page 570) in its decision in *Winter Realty & Construction Co. v. Commissioner of Internal Revenue,* 149 F. (2d) 567: (Appendix C, pages 48 to 57 inclusive)

> "Congress meant to suspend tax only when an owner forced out of one investment, found an equivalent investment, and the money lent on a mortgage is not the equivalent of real property, either as to its management, or as to the security which it affords, or as to the return obtained from it."

A comparison of the old and new properties in Winter Realty & Construction Co. (supra) is set forth in detail in Appendix B, pages 45 and 46. The Petitioner submits that both properties in the instant case are "business" properties "used" by the taxpayer "for rental income purposes," and that there is just as much similarity, in this case, between an improved plot of land which was located in an industrial section of the City of Pittsburgh, (the highest and best use of which was as industrial property, not as a parking lot) and the industrial property which the Petitioner rented as a warehouse, as there was in the *Steuart Brothers* case supra, between a warehouse and a garage and as there was in the *Winter Realty & Construction Co.* case supra, between a bicycle repair shop and a Christian Science Reading Room, or a liquor store and a vacant lot. The common factor, of course, is the fact that they were all properties which the Petitioner used in his business, i.e. real estate invested in by the taxpayer and used by tenants, who pay rent to the taxpayer. The industrial

property of the Petitioner which was condemned was an investment, and so likewise was the new property in New Castle which was acquired with the condemnation award money.

The Court of Appeals for the Third Circuit stated in the instant case:

> "We do not subscribe to taxpayer's contention that the non-recognition of gain provisions of Section 112(f) are available to him, simply because both properties were used by him for the same 'use' —the production of rental income. Nor do we agree with him that the two properties are 'industrial' and thus 'similar or related in service or use' within the meaning of the statute.
>
> "The fact that the taxpayer 'used' the money invested in the old and new properties for the similar purpose of producing rental income does not bring into play the non-recognition gain provisions of Section 112(f) and is impertinent to its application."

The decision of the Court of Appeals for the Third Circuit in the instant case is clearly in direct conflict with the decision of the Court of Appeals for the Second Circuit, in the *Winter Realty & Construction* case supra, where Judge Learned Hand held:

> "Congress meant to suspend tax only when an owner, *forced out of one investment, found an equivalent investment, ...*" (Emphasis ours)

The disagreement between the Circuits centers upon their divergent views as to whether "use" means the objective "use" to which the property is put, i.e., as a warehouse v. a parking lot—or is "use" to be construed in a "subjective" sense; that is, "use" from the standpoint of the particular taxpayer.

Applying the "objective test" rather than the "subjective test" is in direct conflict with this Court's decisions on the interpretation of income tax statutes. See, *Woolford Realty Co. v. Rose*, 286 U.S. 319 (1932) and *Comm. v. McWilliams*, 331 U.S. 694 (1947).

It is the Petitioner's position that if a literal interpretation of the statute favors the objective test employed by the Court of Appeals for the Third Circuit—the use of the property as a warehouse—it amounts to, for all practical purposes, a denial of the benefits of the statute to taxpayers such as the Petitioner whose business is renting real estate.

The editor of *"Lawyer's Weekly Report"* dated February 29, 1960, published by Prentice-Hall, Inc., comments on the issue as follows:

> "POSTPONING GAIN ON CONDEMNED PROPERTY—Third Circuit's adoption of 'functional use' test can affect tax-free replacement of condemnation proceeds in spite of liberalizing nature of '58 law change.
>
> "Assume your property is destroyed or condemned and the insurance or condemnation proceeds exceed your basis. Is there any way to postpone taxation of the gain? Yes—there's no immediate tax if, within a specified period, the proceeds are used to buy property 'similar or related in service or use' (Sec. 1033). But this has been narrowly construed. The Treasury and Tax Court both say that the new property must be put to a *functional use* similar to that of the old. And the Third Circuit now agrees:

"Landlord rented out property as a parking lot. When the State took over this property, he used the condemnation proceeds to acquire all the stock of a corporation whose sole asset was property which he then leased for warehouse purposes. Landlord claimed non-recognition of gain: Both the old and new properties were used by him for the production of rental income.

"The Circuit Court, however, felt the 'similar-in-use' test was not met. The old property was *used* as a parking lot—the new, as a warehouse. That both were rental properties did not control *McCaffrey*, 5 AFTR 2d 777, aff'g 31 TC 505).

"But compare this: The Fourth Circuit has rejected the 'functional use' rule and deferred tax on the gain where Landlord bought new *rental* property to replace old *rental* property. That the activities of the *tenants* were different wouldn't operate to deny non-recognition (*Steuart Bros.*, 261 F. 2d 580, 3 AFTR 2d 318).

"NOTE—The Fourth Ciricuit said that a comparison of the uses would be relevant, for instance, where the owner rented the old property and used the new property in its *own* business (*Lynchburg Nat'l Bank*, 208 F. 2d 757, 45 AFTR 24)."

The independent editorial comment of the editor of the *Tax Fortnighter*, written after the decision of the Tax Court in the instant case, is reported at *1957 Annual Tax Fortnighter, Page 843*. This states, in the words of that editor, the taxpayer's position as he understands it. It is substantially in accordance with the taxpayer's position. We quote:

"(1) The statutory language is not explicit beyond reasonable doubt and should be applied in furtherance of the general purpose of the statute. (2) Tax statutes must be interpreted in terms of application to the particular taxpayer involved (and not some other taxpayer). In other words, the statute must be interpreted as if it read that the replacement must be in 'property similar or related in service or use (by the taxpayer) to the property so converted'—that is, the use by the lessor here, not the use by the lessee. (3) It is not unreasonable to say that the 'service or use' of the property by the lessor is the renting of it to others. For example, rental property has been held to be property 'used' in the owner's trade or business for capital gain or loss purposes. See *Gilford,* C.A. 2, 201 F. 2d 735, 1953 ANNUAL T. F. 187.

"If it be argued that under this view any replacement, of whatever character, would qualify, putting this class of taxpayer in a favored position, the taxpayer's answer is that, the other view puts it in a less favorable position than other taxpayers and that its interpretation is the more reasonable one for effectuating the statute."

The indepenedent editorial comment as reported at the *Tax Fortnighter* for February 20, 1960 at page 201 comments as follows:

"The Missing Link?"

"Sec. 112(f), 1939 Code, as does Sec. 1033(a)(3)(A), 1954 Code, provided for nonrecognition of gain if during the specified period, the taxpayer, 'for the purpose of replacing the property

so converted, purchases other property similar or related in service or use to the property so converted * * *.'

"The Third Circuit sees no basis in the foregoing language for the distinction drawn by the Fourth Circuit between 'investors' and 'users' in applying the statute in the Steuart Bros. case. The basis, we believe (as we set forth in criticizing the Tax Court's decision (29 T.C. 372) in the Steuart Bros. case, which the Fourth Circuit subsequently reversed, 1957 ANNUAL T.F. 841), is in a 'missing link, which must be interpolated into the statute—i.e., the words 'by the taxpayer.' To get the real meaning of the statute it must, necessarily, be read as if it required that the taxpayer, 'for the purpose of replacing the property so converted, purchases other property similar or related in service or use (by the taxpayer) to the property so converted.'

"Where a taxpayer owns a warehouse property and leases it to another party for income, the service or use of the property is as a warehouse, but that is not the service or use to which it is being put by the lessor. The latter is using it as an investment to obtain rental income, and any other rental property should suffice as a replacement.

"The purpose of the statute in requiring replacement with property 'similar or related in service or use' is better effectuated by thus distinguishing between 'users' and 'investors.'"

In summary, the decision of the Court of Appeals for the Third Circuit in the present case places it in irreconcilable conflict with the holdings of the Fourth

Circuit and the Second Circuit. Accordingly, we respectfully urge the Court to issue the Writ of Certiorari here sought, and reconcile the conflict by reversing the judgment of the Third Circuit.

II. The Determination of the Rights of Taxpayers Whose Property Has Been Condemned, Destroyed, Stolen, Seized or Requisitioned and the Tax Results When Such Property Is Replaced Is a Question of Importance in the Administration of the Federal Income Tax Laws Which Has Not Been, But Should Be, Settled by This Court.

This Court can take notice of the increase in rental or leasing rather than outright purchase of real estate, plants, equipment, machinery, automotive trucks and automobiles, office equipment, tools, and the like.

We have many examples of leasing as distinguished from ownership in the housing field. In recent years, more and more industries have found it advisable to rent their plant buildings rather than own them. Many industrial organizations have disposed of their office buildings and have rented other office buildings. There has been a great number of new motels built due to the great increase in travel by the American people since World War II. It is commonplace for business firms engaged in the heavy construction industry to rent most of their equipment. Automobiles and trucks and the rental of the same as compared with ownership has become a substantial business. Witness the presence in all large cities and in many small cities of the automotive rental companies. Office equipment has also been the subject of more and more rental arrangements in the recent years. This is

particularly true in the high-cost electronic computer equipment field, where few industries or even the Government find it economically feasible to own, as distinguished from renting, such high-cost complex items of equipment which well may be obsolete in a few years.

Further, there has been a substantial increase in the amount of condemnation proceedings which have taken place since the inception of the Federal highway program. Due to the fact of the great increase in automotive traffic many cities have found it necessary to relocate their highways and streets at considerable condemnation cost. This has brought about a large amount of relocation of rental properties.

In recent years in the larger cities in the East, many of the large mercantile department stores have seen fit to transfer their activities from crowded, congested, central city locations to the suburbs and in most instances such properties and the equipment therein is rented. This has been occasioned by reason, in some instances, of condemnation proceedings.

If the nation is to continue to grow and expand, the problem of replacement of property that has been condemned will continue for some period of time. Much of this condemnation has taken place in years prior to 1958 and the replacement of such condemned property is the subject of litigation for tax purposes as is the instant case.

As the public gives wider acceptance to the use of rental and leasing arrangements as distinguished from purchases of plants, equipment, machinery, automobiles, office equipment, etc., more and more often will the question of replacing the same arise. Since, with the increase

in population of the country, it is reasonable to assume that an important segment of such property will be destroyed in whole or in part by fire or other casualty, will be a subject of theft, and from time to time may be the subject of seizure or requisition.

When such events take place, such property must often be replaced. If there is to be restrictive decisions of the Courts on the question of replacement "in property that is similar or related in service or use", much hardship will be imposed upon taxpayers. This is particularly true since the tax incidents are occasioned to a taxpayer not by his own acts, but by the acts of others over whom he has no control.

It is true that for post-1958 years, Congress, by passing Section 46 of the Technical Amendments Act of 1958, P. L. 85-866, 72 Statutes 1606, Senate Report No. 1983, 85th Congress, 2nd Session, pages 71 and 72, did liberalize the provision applying in this area to the replacement of condemned real property. In this connection we quote from *Lawyer's Weekly Report* dated February 29, 1960, published by Prentice-Hall, Inc., as follows:

> *"The 1958 law change*: Unlike the 'similar-in-use' provision of Sec. 1033, a liberal construction has been given the 'like-kind' test for the *voluntary* tax-free exchange of business and investment property (Sec. 1031). For example, an exchange of unimproved or improved real estate meets the test. What does this have to do with our problem? The 1958 Mills Act adopted this easier 'like-kind' rule for post-1957 *condemnations of business or investment real property*. So, even the Treasury agrees

that the *Steuart* situation, if it arose today, would qualify under the easier, 'like-kind' test.

"CAUTION—That's not the whole story on the new law, though. It does not apply to involuntary conversions by fire or other casualty. Nor does it cover the situation where *condemnation* proceeds are used to purchase 80% control of a corporation owning the replacement property. In such a case, the position of the Revenue Service and the courts on the interpretation of 'similar or related in service or use' will continue to govern. Thus, if the proceeds are used to purchase control of a corporation owning the new property rather than investing directly in the new property—as the facts were in *McCaffrey*—the Third Circuit today would still tax the gain (as would the Treasury and Tax Court), while the Fourth Circuit (under its *Steuart* reasoning) would grant non-recognition."

Confusion is present in view of the divergent opinions of the Courts of Appeal for the Third, Fourth and Second Circuits on the question of the replacement of rental real estate in pre-1958 years. The 1958 legislation will, for years in the future, eliminate the confusion on the question of the replacement of property in the nature of rental real estate which has been condemned. However, it will not end the confusion which will continue to be present in the other areas of involuntary conversions by fire or other casualty, etc.

In view of the divergence of opinions of the Circuits, the effect upon the administration of the tax laws is obvious. Taxpayers in the Fourth and Second Circuits have one guide in the replacement of property area;

taxpayers in the Third Circuit have another guide on the same question.

Although the Tax Court, in its opinions in the past, has not always been consistent, it would appear that its decision in the instant case and in *Steuart Brothers* would appear to indicate the Tax Court's acceptance of the "functional test" on this question to the exclusion of other tests.

Hence, taxpayers and the Treasury representatives, at least in the populous areas which comprise the Second and Fourth Circuits, have no guide short of litigation by which differences between them, in the field of the involuntary conversion of property and its replacement, may be administratively adjusted. The Treasury Department is understandably reluctant to abandon its position of taking the restrictive "functional test approach" in this field. Furthermore, taxpayers reviewing the divergent opinions of the Courts of Appeal lack standards by which their own arrangements may be satisfactorily made.

This important area of the law is bound to increase in view of the current trend to leasing as distinguished from outright ownership of so many items whch can be involuntarily converted by reason of fire, wreck, tornado, and various other casualties.

Hence, this whole important area of the tax law urgently requires consideration by this Court. This Court should establish clear views for the guidance of taxpayers and the Treasury alike. For this reason we respectfully urge the Court to issue the Writ of Certiorari here sought.

CONCLUSION

We wholeheartedly concur in the views expressed by the Fourth and Second Circuits on the question of replacement of condemned rental real estate.

It is submitted, therefore, that this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

ROBERT G. MACALISTER
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Pittsburgh 19, Pa.
Attorney for Petitioner

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

NO. 12,895

THOMAS McCAFFREY, JR., ET AL.,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

Argued November 2, 1959

Before McLAUGHLIN, KALODNER and HASTIE,

Circuit Judges

Opinion of the Court

(Filed February 10, 1960)

By KALODNER, *Circuit Judge*

This petition for review of the Decision of the Tax Court of the United States[1] concerns the applicability of the "nonrecognition of gain" provisions of Section 112(f) of the Internal Revenue Code of 1939, as amended.[2]

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1. The Decision of the Tax Court is reported at 31 T.C. No. 52 (1958).

2. Section 112 provides in part:

"SEC. 112. Recognition of gain or loss—

"(a) *General rule.* Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

"(f) [as amended by Sec. 1, Act of October 31, 1951, c. 661, 65 Stat. 733] Involuntary Conversion.—If property (as a result of its destruction in whole or in

The issue presented is whether the Tax Court erred in holding that property acquired by the taxpayer with the proceeds he received from the condemnation of his parking lot property was not "similar or related in service or use" to the condemned property.

The critical facts may be stated as follows:

Thomas McCaffrey, Jr., the petitioner ("taxpayer")[3] has been engaged in the business of industrial

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part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) *Conversion into similar property.* Into property similar or related in service or use to the property so converted, no gain shall be recognized.

* * * * *

(3) *Conversion into money where disposition occurred after 1950.* Into money or property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) nonrecognition of gain. If the taxpayer during the period specified in sub-paragraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. . . ." 26 U.S.C. 1952 ed., Sec. 112.

3. Mr. McCaffrey's wife is also a petitioner here, but solely because she filed a joint return with her husband.

realtor and appraiser in and about Pittsburgh, Pennsylvania since 1923. In 1947, he acquired, at a cost of $15,000 a co-ownership interest in a property in Pittsburgh occupied as a parking lot. The lot was 80 by 180 feet. It had on it only a small frame building adaptable for use in the operation of a parking lot. The property was filled, graded and blacktopped. It was served by the usual utilities—water, gas, electricity and telephone. It also had a railroad siding which was unused. In 1923, and for an undisclosed period thereafter prior to 1947, the property was used as a coal yard. Neighboring properties were industrial in nature.

At the time taxpayer acquired his interest in the Pittsburgh property it was under lease as a parking lot. It remained so during the entire period of his co-ownership under annual leases which provided that the property could be used only for parking purposes.

In 1952, the Commonwealth of Pennsylvania condemned the Pittsburgh property and taxpayer was awarded $57,477—an excess of $42,477 over his $15,000 cost. Subsequently, he sought to acquire an industrial property of similar size in Pittsburgh but was unable to find any "to accommodate my [his] desires". However, he found available, in the City of New Castle, Pennsylvania, about fifty miles from Pittsburgh, a 9⅓ acre tract, industrially zoned, owned by the American Can Company. It had on it a two-story 694 x 80 feet building of brick and wood construction with concrete and wood floors, equipped with elevators, sprinkler and heating systems. It also had an engine room, garages and lumber shed. A part of the tract was surfaced with blacktop and cinders and was used for parking purposes by executives, employees and customers of a corporation

conducting business on an adjacent property; another part had cinder surfacing for use in parking incidental to unloading shipments by rail on two Baltimore & Ohio sidings which served the property.

Coincident with his learning of the availability of the New Castle property taxpayer also ascertaned that the Federal Civil Defense Administration ("Administration") had previously considered leasing it but had not done so because of the physical condition of the buildings. He thereupon entered into negotiations with Administration to lease the property and obtained a lease commitment provided certain repairs, alterations and improvements were made. Taxpayer then negotiated the purchase of the property by the Arsenal Corporation, a Pennsylvania corporation, from the American Can Company at a price of $155,000, of which $105,000 was represented by a mortgage on the property to the American Can Company. Thereafter, in August, 1953, taxpayer purchased all of the stock of the Arsenal Corporation for $64,029. At the time the New Castle property was the Arsenal's sole asset. Subsequently, Arsenal leased the New Castle property to Administration on a year-to-year basis for use for warehouse purposes and expended approximately $100,000 in making the repairs and improvements called for by the lease commitment. The rental paid by Administration did not include any amount as a charge for its use of the property for parking purposes.

In determining the tax deficiency in issue, the Commissioner determined that taxpayer was not entitled to the benefits of the "nonrecognition of gain" provisions of Section 112(f), and, accordingly that the gain of $42,477 realized from the condemnation of taxpayer's

interest in the Pittsburgh property constituted long-term capital gain taxable in 1953. The Tax Court agreed on the ground that the New Castle property, acquired by taxpayer through stock ownership of the Arsenal Corporation, was not property "similar or related in service or use" to the Pittsburgh property within the meaning of Section 112(f). This petition for review followed.

The sum of taxpayer's contention here is that he "is in the busines of investing in industrial real estate for the purpose of producing income therefrom" and since "both the condemned property and the replacement property were industrial properties which served the same function, use and purpose" to him, to wit, "producing rental income therefrom" that the purchased property is "similar or related in service or use" to the one converted within the meaning of Section 112(f).

There are then two arrows in the quiver of taxpayer's contention: (1) it is the "service or use" to which he put his money for the production of rental income in the two properties involved, rather than the "service or use" which the properties were designed to afford, or their physical characteristics, which is dispositive; and (2) the two properties were in fact similar in "service or use" in that they are both "industrial properties".

The Tax Court erred, says the taxpayer, in disregarding the factors stated, and applying instead a "functional test" to establish whether the Pittsburgh and New Casle properties were "similar or related in service or use", viz., the "purpose" or nature of the properties themselves.

We do not subscribe to taxpayer's contention that the nonrecognition of gain provisions of Section 112(f) are available to him simply because both properties were used *by him* for the same "use"—the production of rental income. Nor do we agree with him that the two properties are "industrial" and thus "similar or related in service or use" within the meaning of the statute.

The fact that taxpayer "used" the money invested in the old and new properties for the similar purpose of producing rental income does not bring into play the nonrecognition of gain provisions of Section 112(f), and is impertinent to its application.

The statute provides in two separate sub-sections that in order to qualify for its nonrecognition of gain relief there must be a "conversion into similar property" and "similar property" is defined as "similar or related in service or use to the property so converted". The sub-sections referred to are (f)(1) and (f)(3)(A).

Sub-section (f)(1) provides in part:

"*Conversion into similar property.* Into property similar or related in service or use to the property so converted . . ."

Sub-section (f)(3)(A) provides in part:

"nonrecognition of gain. If the taxpayer during period specified in sub-paragraph (B), for the purpose of replacing the property so converted, purchases *other property similar or related in service or use to the property so converted* . . ." (emphasis supplied)

Section 112(f) is not concerned with "why" taxpayer invests the proceeds of the converted property,

but only "how" he does so, viz., into "similar or related in service or use" property.

That brings us to consideration of taxpayer's contention that the Pittsburgh and New Castle properties are "similar" because, he says, they are both "industrial".

We cannot subscribe to this contention.

First, we do not think that the Pittsburgh parking lot property can be considered "industrial", because the word "industrial" in its accepted connotation denotes "the processes or products of manufacture, or commercial production in general".[4] By no stretch of the imagination can the use of a lot for the public parking of cars be considered an "industrial" use. On the other hand, the New Castle property, in its state prior to its acquisition by taxpayer and subsequent thereto, was within the classification of "industrial" property.

We next consider the question as to whether the Pittsburgh and New Castle properties were otherwise "similar or related in service or use".

Taking first the Pittsburgh property:

It was 80 x 180 feet in size, filled, graded and blacktopped, and had on it "a small frame building which was adaptable for use only in the operation of a parking lot".[5] The property had been leased and used for public parking prior to taxpayer's acquisition of an interest in it in 1947; it continued so under his ownership for some five years until the condemnation in 1952. There is not

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4 Funk & Wagnalls, New Standard Dictionary of the English Language.

5 As stipulated by the parties.

even a contention that taxpayer prior to the condemnation had planned to change the physical character of the Pittsburgh property or its use. Thus, the conclusion is inescapable that the "service or use" of this property was as a public parking lot and that only.

As to the New Castle property:

It was more than nine acres in size and had erected on it these structures: a two-story building, 694 x 80 feet in dimension, equipped with elevators, sprinkler and heating systems, an engine room building, garages and lumber shed. While an undisclosed portion of the property was surfaced with blacktop and cinder and was used for parking purposes by an adjacent factory, it is clear that this was not merely a "parking lot" property. It may be noted, parenthetically, that the parking by the adjacent factory ceased after taxpayer's acquisition and the entire tract was "fenced-in". Further, while the record does not disclose whether the American Can Company used the property for warehousing purposes during its ownership or occupancy, the record establishes that taxpayer (via Arsenal Corporation) leased the property to the Civil Defense Administration solely for warehouse purposes and further that $100,000 was expended in making repairs, alterations and improvements to the property to make it usable for such purposes. Indeed, taxpayer did not (via Arsenal) buy the New Castle property until he had obtained a commitment for its rental to the Administration as a "warehouse".

In summary, then, the Pittsburgh property was suitable and used for public parking lot purposes and the New Castle property was suitable and used for ware-

house purposes. Clearly they were not "similar" properties, physically or otherwise, nor were they "similar or related in service or use".

It would serve no useful purpose to review the numerous cases in which the courts have dealt with "nonrecognition of gain" since in each instance they were decided on their particular facts, except with respect to Steuart Brothers, Inc. v Commissioner, 261 F.2d 580 (4th Cir. 1958) on which taxpayer premises his contention.

In Steuart the converted real estate was held for rental purposes and the proceeds of the condemnation were reinvested in real estate so as to produce rental income.[6] The Fourth Circuit granted nonrecognition of gain on its holding that (p. 584):

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6 In Steuart Brothers, Inc. v Commissioner, taxpayer, a corporation, was engaged in the business of acquiring improved and unimproved realty for investment purposes. In 1948 it purchased a four and one-half acre tract of commercially zoned land in Washington and subsequenty planned to improve the land with two warehouse properties and negotiated their leasing to two different parties. It was, however, unable to proceed with construction because of the imminence of condemnation proceedings which did in fact ensue. The proceeds of the condemnation were used by the taxpayer to acquire three properties. One of the properties was occupied in part by a one-story building used as automobile salesrooms, garage and service station and the remainder used as a parking and used car lot. The entire property was under a lease to an automobile dealer. The second property was improved in part with two one-story buildings used as automobile showrooms, automotive repair shop, garage and service station and the remainder as a parking and used car lot. This property, too, was leased to an automobile dealer. The third prop-

"In our view the taxpayer . . . is entitled to the benefit of the statute because the original real estate was held by it for investment purposes and the proceeds of the condemnation were reinvested in real estate of the same general class".

In doing so it drew a distinction between situations where the taxpayer had himself used both the converted property and its replacement and those where both the old and new properties were held by the taxpayer for investment purposes and not "used" by him. It indicated that the "functional test" applied in the first instance but not in the second, and that in the latter the test was simply whether the two properties were in "the same general class".

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erty was improved with a two-story building used as a service station prior to taxpayer's purchase and subsequent to it by the operator of a fleet of taxicabs.

In deciding that the condemned tract was of the "same general class" and therefore similar within the meaning of Section 112(f) to the three properties which replaced it, the Court said at pages 582-583:

". . . The taxpayer's vacant land . . . had been definitely committed by contract to specific uses, which should be compared with the uses to which the land purchased with the proceeds of the condemnation award was actually devoted. Two buildings were designed for the original tract: (1) a one-story building to be leased to and used by a retail grocery store, and (2) a one-story warehouse to be leased to the Manor Real Estate and Trust Company. The new properties were devoted generally to usages of the automobile business, the Rhode Island and Third Street properties were automobile showroom, repair shop, garage-service station, and parking lot by an automobile dealer; the Fourteenth Street property as a service station by

The Court's finding in Steuart that there the converted real estate and its replacement were "of the same general class" is of course an ultimate finding of fact with which we are not here concerned, although as fact-finders often do, we might have arrived at an opposite determination on the score of such classification. Insofar however, as the test of classification was motivated by the Court's view that different standards are to be applied in such classification because of the status

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the operator of a fleet of taxicabs. A comparison between these uses would be relevant if the taxpayer itself had used or intended to use the original land for the planned purposes and later, after the condemnation, had itself used the new land in the same way as its tenants used it. But the taxpayer was not in possession and did not itself actually use the newly acquired properties for any purpose. It held them for an investment exactly as it had previously held the condemned properties; and it is manifest that the purpose of the statute will be served if the taxpayer is not compelled at this time to recognize the gain which it was compelled to realize by the condemning power."

And at page 584:

"The Tax Court cites a number of decisions in which it found that the required similarity of use did not exist; but in these cases the use of the property by the taxpayer itself before the involuntary conversion took place was compared with the use of the new property by the taxpayer itself thereafter. There was no comparison of investments in real estate held by the taxpayer before and after the conversion, but not used by the taxpayer itself. In our view the taxpayer . . . is entitled to the benefit of the statute because the original real estate was held by it for investment purposes and the proceeds of the condemnation were reinvested in real estate of the same general class."

of the owners of the properties— investors versus users —we must say that we cannot discern in Section 112(f) any basis for the application of varying standards in determining whether there has been a "conversion to similar property" or whether the replacement property is "similar or related in service or use to the property so converted".

There remains for consideration the Commissioner's contention that the Pittsburgh property was "unimproved" whereas the New Castle property was "improved" thus calling into play the provisions of Treasury Regulations 118, Sec. 39.112(f)-1(c)(9) which state:

> "There is no investment in property similar in character and devoted to a similar use if—
>
> > "(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate".

In support of his contention that the parking lot is "unimproved" property Commissioner cites Feist v. Fifth Avenue Bank, 280 N.Y. 189, 20 N.E.2nd 388, 389 (1939) where it was held that "improved" real estate is ". . . land which is substantially enhanced in value by some probably durable structural improvement".

We deem it unnecessary here to consider this contention because of our view that the Pittsburgh and New Castle properties were not similar or related in service or use within the meaning of Section 112(f), irrespective of the question as to whether the Pittsburgh property was "improved" or "unimproved".

For the reason stated the Decision of the Tax Court will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

APPENDIX B

[From 1959 Federal Tax Reports]

STEUART BROTHERS, INC., a corporation, Petitioner vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.

U. S. Court of Appeals, 4th Circuit, No. 7669, 12/17/58. Reversing Tax Court, 29 TC 372, CCH Dec. 22,675.

Before SOPER and HAYNSWORTH, Circuit Judges, and WATKINS, District Judge.

SOPER, Circuit Judge: This petition for review presents the contention of the taxpayer that under § 112 of the Internal Revenue Code of 1939, no taxable gain was involved in a condemnation award of $425,000 from the United States whereby the taxpayer realized a gain of $349,058.54. The statute provided:

> "Sec. 112. Recognition of Gain or Loss.
>
> "(f) *Involuntary Conversion.*—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—
>
> "(1) *Conversion into similar property.*—Into property similar or related in service or

use to the property so converted, no gain shall be recognized."

Since the property was taken by the United States in a condemnation proceeding the first requirement of the statute was satisfied; but the Tax Court held [CCH Dec. 22,675] that the property had not been converted into property similar or related in service or use to the property condemned and therefore approved a determination of a tax deficiency of $81,162.37 for the calendar year 1951.

Steuart Bros., Inc., a Delaware corporation, has been engaged in the real estate business in Washington, D. C., since January 2, 1925, consisting principally of acquiring improved and unimproved realty for investment purposes. The taxpayer constructed buildings for rental purposes on vacant land designed for a variety of purposes according to its own plans or the specifications of the lessees. Substantially all of the taxpayer's income has been derived from the rental of investment property.

Early in 1948, the taxpayer purchased approximately four and one-half acres of commercially zoned vacant land at East Capitol Street and Blaine Street, S. E., near Kenilworth Avenue, west of the Pennsylvania Railroad tracks in northeast Washington. The land cost $33,181.00 and the taxpayer spent the additional sum of $37,750.46 in clearing and preparing it for commercial use, making the total investment $70,941.46. In the summer of 1949, the taxpayer entered into a written agreement with Square Deal Market Company, Inc., an operator of a chain of retail grocery stores, to construct a large one-story building on the southwest portion of the land for use as offices, warehouse, and storage space and

leased it to Square Deal for the period of ten years with certain extensions. On December 13, 1949, the taxpayer filed with the officials of the District of Columbia an application for a permit to erect the building, but the permit was refused because the officials intended to take this portion of the property by condemnation for the purpose of extending East Capitol Street in conjunction with the erection of the East Capitol Street bridge.

Early in 1950, the taxpayer entered into a written agreement with Manor Real Estate and Trust Company to construct a large one-story warehouse, with parking area on the remainder of the land to be leased to the Manor Company for the term of 10 years, renewable on a monthly basis. Accordingly, on September 18, 1950, the petitioner filed an application with the Washington officials to erect the building, but the permit was refused because the officials intended to condemn this portion of the land also in order to provide access to the East Capitol Street bridge.

Thereafter the entire property was condemned and on December 18, 1950, the taxpayer was granted an award of $425,000 by the District of Columbia and realized the gain in question. The entire sum was deposited in a special banking account.

During 1951 and the early part of 1952, the taxpayer investigated vacant land as well as improved realty in the Washington metropolitan area for the purpose of replacing the condemned property. On June 5, 1952, taxpayer purchased for $376,170.00 property at 1401 Rhode Island Avenue, N. E., on part of which was located a one-story building used as automobile salesrooms, garage, and service station, the remainder of the property being

used as a parking and used-car lot. At that time the property was under a lease (expiring in 1956) to an automobile dealer, and since 1956 has been leased to Continental Motors, Inc.

On December 31, 1952, the taxpayer purchased from Continental Oil Company two parcels of property for the total purchase price of $236,425.28, one of which is located at Third and H Streets, N. E., and the other at Fourteenth and Swann Streets, N. W., in Washington. The Third Street property is improved by two one-story buildings used as automobile showrooms, automotive repair shop, garage and service station, and the vacant portion of the land is used as a parking and used-car lot. It was then under lease to Steuart Motor Co., Inc., an automobile dealer, and is still under lease to that company. The Fourteenth Street property is improved by a two-story building used as a service station and was under lease at the time of its acquisition to an individual named Bonifant. It is now leased to the operator of a fleet of taxicabs. The award of $425,000 was expended as follows:

Attorney's fee	$ 5,000
Purchase of Rhode Island Avenue property	376,170
Part payment of the purchase price of the Third and Fourteenth Street properties	43,830

The balance of the purchase price of the last named properties, amounting to $192,655.58, was supplied by the taxpayer from other funds.

[*Functional Use of Replacement Property*]

The question that is proposed is whether real property, held by the owner for investment but condemned for public use, is converted into similar property within the meaning of the statute when the proceeds of the award are invested in other real property of the same general character. On the face of the matter, the answer would seem to be in the affirmative because the obvious purpose of the law is to relieve the owner of property of the immediate payment of a capital gains tax when he does not liquidate his holding of his own will but parts with it involuntarily by virtue of superior governmental power, or loses it through circumstances over which he has no control. The Tax Court has taken a narrower view. It agrees that exact duplication of converted property is not required but it holds that the new property must be put to a functional use similar to that of the old so that, in the words of the statute, there is a "conversion into property similar or related in service or use to the property so converted." It says that it is not enough for the taxpayer to show that he is in the business of acquiring and holding real property for investment and that both the old and the new property were actually held for that purpose.

We had occasion to apply the statute in *Lynchburg National Bank & Trust Co. v. Commissioner*, 208 Fed. (2d) 757 [54-1 USTC ¶9128]. The bank, in order to increase the size of its quarters, purchased the adjacent property intending to demolish the building on it and to erect an addition. But the plan was delayed by the war and the bank rented the old building to tenants, in part for a shoe store and in part for a restaurant. Subsequently half the building was damaged by fire and torn

down and later the remainder of the building was demolished and the addition to the banking house was built. The bank claimed that the case was covered by the statute and hence the proceeds of the fire insurance policy on the burned building should not be included in computing its income for the year when they were received. We rejected this contention, holding that the uses to which the property was put before and after the change were not so similar as to bring the case within the terms of the statute. Before the fire and the demolition of the original building the property served as an investment of the bank and was used by the bank's tenants for a shoe store and a restaurant, while afterwards it was used by the bank itself as its place of business. The present case does not present such a dissimilarity. The taxpayer's vacant land on East Capitol Street had been definitely committed by contract to specific uses, which should be compared with the uses to which the land purchased with the proceeds of the condemnation award was actually devoted.[1]

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[1] Under these circumstances it would be unreasonable to apply the provision of Treasury Regulations 111, § 29.112(f)-(i), which declares that there is no investment in property similar in character if the proceeds of unimproved real estate are invested in improved real estate. The Tax Court made a similar holding in *Gaynor News Co.*, 22 T. C. 1172 [CCH Dec. 20,549], where the taxpayer demolished a building in order to erect a new building for its business and after the land was cleared and before the new building was erected the property was condemned and the taxpayer bought new real estate on which there were improvements, some of which were retained for the conduct of the business. The court said: "* * * In the case before us, the function and purpose of the old property, from petitioner's perspective, was identical with that of the new. The mere fact that the old property was bare of im-

Two buildings were designed for the original tract: (1) a one-story building to be leased to and used by a retail grocery store, and (2) a one-story warehouse to be leased to the Manor Real Estate and Trust Company. The new properties were devoted generally to usages of the automobile business, the Rhode Island Avenue and Third Street properties for automobile showroom, repair shop, garage-service station, and parking lot by an automobile dealer; the Fourteenth Street property as a service station by the operator of a fleet of taxicabs. A comparison between these uses would be relevant if the taxpayer itself had used or intended to use the original land for the planned purposes and later, after the condemnation had itself used the new land in the same way as its tenants used it. But the taxpayer was not in possession and did not itself actually use the newly acquired properties for any purpose. It held them for an investment exactly as it had previously held the condemned properties; and it is manifest that the purpose of the statute will be served if the taxpayer is not compelled at this time to recognize the gain which it was compelled to realize by the condemning power.

Prior decisions of the Tax Court have adopted this view. In *M. J. Calbeck Corp.*, 36 B. T. A. 452 [CCH Dec. 9740], the taxpayer owned an opera house which had

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provements at the precise moment of conversion, while the new property had, when acquired, improvements fortuitously useable, in part, in furtherance of petitioner's clearly planned purposes (but to a substantial extent unusable, and actually an obstruction when viewed in the light of intended use) does not alter the basic identity of function, purpose and use for which both the old and the new property were acquired by petitioner."

been remodeled to provide two stores on the ground floor and a moving picture theatre above. After a fire which destroyed the building the taxpayer leased the property and agreed to construct a new building to be used by the tenant for a department store. The decision went against the taxpayer because the replacement of the investment was not made "forthwith" as required by the provisions of the section as it appeared in the Internal Revenue Act of 1932. But in passing on the comparative uses of the property the Tax Court said (page 454):

> "We think it beyond serious question that the old and the new buildings were 'similar or related in service or use' within the meaning of the statute. Both were business properties; in the old, part of the income was from rents from stores on the ground floor and part from the operation of a motion picture theater; in the new, the income was from rents from ground floor stores. There were differences in the type of construction and the height and depth of the buildings, but the statute does not require exact physical duplication. *Cotton Concentration Co.*, 4 B. T. A. 121 [CCH Dec. 1457]."

Again in *Winter Realty & Construction Co. v. Commissioner*, 2 T. C. [CCH Dec. 13,251], the Tax Court had occasion to consider the case of a realty company which owned five parcels of real estate that were condemned by the City of New York. It invested part of the condemnation award in mortgages and part in real estate. It was held that the mortgages were not similar properties but that the new real estate was similar to the old within the meaning of the statute. A comparison of the old and new properties shows that they dif-

fered from each other quite as much as the old and new properties in the instant case. Winter's original properties included a bicycle repair shop, a motorcycle salesroom, a brick warehouse, a concrete garage, a frame shop occupied by an automobile accessory business and a two-story frame residence, and a store occupied as a barber shop, a frame dwelling containing nine apartments, hardware store, cigar store, tailor shop, etc. The new properties consisted of a brick building erected on a lot owned by the taxpayer occupied on the lower floor by butcher, liquor and barber shops, and on the upper floor by a chiropodist's office, an employment office, and a Christian Science Reading Room. Other new properties consisted of vacant land on which the taxpayer erected buildings or intended to erect them, also a building divided into four stores, and, also, a building used in part as a cafe. In passing on the similarity of the uses of the property, the Tax Court said:

> "We have found in our findings that the petitioner did so expend $96,830.19 of the award money which it received. Our findings in this respect are quite full in that they set out in considerable detail the kind of property that was condemned and the kind of property that was acquired in its place. We are satisified from the evidence that the property acquired in the amount of $96,830.19 was similar or related in service or use to the property taken, and have so found as a fact, * * *"

The Tax Court cites a number of decisions in which it found that the required similarity of use did not exist; but in these cases the use of the property by the taxpayer itself before the involuntary conversion took place was compared with the use of the new property

by the taxpayer itself thereafter.[2] There was no comparison of investments in real estate held by the taxpayer before and after the conversion, but not used by the taxpayer itself. In our view the taxpayer in the present case is entitled to the benefit of the statute because the original real estate was held by it for investment purposes and the proceeds of the condemnation were reinvested in real estate of the same general class.

The decision of the Tax Court will be reversed.

Reversed.

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[2] See *Buckhardt v. Commissioner*, 32 B. T. A. 1272 [CCH Dec. 9061]; *Cotton Concentration Co. v. Commissioner*, 4 B. T. A. 121 [CCH Dec. 1457]; *Flaxlinum Insulating Co. v. Commissioner*, 5 B. T. A. 676 [CCH Dec. 1955]; *Haberland v. Commissioner*, 25 B. T. A. 1370 [CCH Dec. 7558]; *Kimball-Diamond Milling Co. v. Commissioner*, 10 T. C. 7 [CCH Dec. 16,204]; *Massillon-Cleveland-Akron Sign Co. v. Commissioner*, 15 T. C. 79 [CCH Dec. 17,783]; *Nehi Beverage Co. v. Commissioner*, 16 T. C. 1114 [CCH Dec. 18,288]; *Washington Market Co. v. Commissioner*, 25 B. T. A. 576 [CCH Dec. 7441].

APPENDIX C

WINTER REALTY & CONSTRUCTION CO. v. COMMISSIONER OF INTERNAL REVENUE. COMMISSIONER OF INTERNAL REVENUE v. WINTER REALTY & CONSTRUCTION CO.

No. 43.

Circuit Court of Appeals, Second Circuit.

May 7, 1945.

Before L. HAND, SWAN, and CHASE, Circuit Judges.

L. HAND, Circuit Judge.

Both parties appeal from an order of the Tax Court which assessed a deficiency against the taxpayer in its income tax for the years 1932, 1935 and 1936; and an additional deficiency in excess profits tax for the years 1935 and 1936. The question involves the proper construction of § 112(f) of the Revenue Acts of 1932, 1934 and 1936, 26 U.S.C.A.Int.Rev.Code, § 112(f). The first question is as to how much of an award granted to the taxpayer upon condemnation of certain real property was "expended in the acquisition of other property similar * * * to the property" condemned, "or in the establishment of a replacement fund." The second question is whether, when an award is paid in installments, spread over more than one year, a taxpayer is entitled to exemption as to all of any installment "expended" in any given year in acquiring "similar property," regardless of what he may have so expended in the past. The taxpayer owned real property in Flushing, New York,

which the City condemned on November 4, 1931, and the "basis" of which was $136,564.83. The net amount of the award, paid in installments and after considerable litigation, was as follows: in 1932—$160,292.81; in 1935—$125,735.57; and in 1936—$101,116.25. The first of these sums the taxpayer deposited in its bank account when paid; an account on which it drew for its general needs, and in which it deposited its current receipts. Out of the first payment it invested $15,000 in 1932 in the purchase of a mortgage on real estate and $45,713.94 in buying "similar property." The Commissioner taxed as "gain" in 1932, the difference—$23,527.98—between the amount so received in that year, and the "basis." In 1935 the taxpayer invested the whole of the installment of that year in mortgages on real property; all of which the Commissioner taxed as "gain," because the "basis" had been fully restored by the first installment. In 1936 the taxpayer invested out of the award of that year, $50,000 in mortgages, and the balance—$51,116.25—in "similar property." The Commissioner assessed the whole payment of 1936 as "gain" because the total of all the sums invested in "similar property"—$45,713.94 plus $51,116.25 — had not equalled the "basis" — $136,564.84.

In closing its books for the year 1932, the taxpayer set up on the liability side of its ledger an account, entitled "Replacement Fund," to which it credited the full amount of the award received in that year. In 1935 it added to this item upon its ledger the award received in that year; and so it did in 1936. In 1932 its vice president and manager, after reading the regulation regarding the establishment of replacement funds, quoted in

the margin,[1] went to the office of the collector, procured the prescribed form in triplicate, filled it out and mailed it to the official in the Brooklyn office to whom he had been told to send it. Later, the taxpayer made several inquiries at the same office about this application, but could learn nothing; apparently, although received, it had been lost, and it never has been found. In making its return for the year 1932 on March 15, 1933, the taxpayer enclosed a letter calling attention to the fact that

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1. "Art. 580. *Replacement fund.* In any case where the taxpayer elects to replace or restore the converted property but it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. (See section 1126 of the Revenue Act of 1926.) The estimated additional taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy."

"there has been set up a figure headed 'replacement fund.' This figure represents sixty per cent of the City's appraisal * * * it is the intention * * * upon receipt of the balance of the award * * * to replace same in property in similar or related in service, or use of the property so converted." The Commissioner never took any action upon this letter. On February 3, 1937, the taxpayer filed a second application, upon the form prescribed for the purpose for "permission" to "establish a replacement fund", but the Commissioner never acted upon this application either. The Tax Court held that the attempt to set up a "replacement fund" failed; that the mortgages were not "similar property or property related in service or use"; but it allowed the sum of $51,116.25 invested in real estate in 1936 as an exemption because it had been invested in that year in "similar property or property related in service or use." This last ruling is the basis of the Commissioner's appeal; the taxpayer appeals from the rulings against it.

[1, 2] Everyone agrees as to the purpose of § 112(f); indeed, it would be impossible to mistake it. An owner, whose property is taken involuntarily, but who has become entitled to compensation, should not be treated as having "realized" a taxable "gain," provided he at once puts the proceeds to a similar use. Such an owner will often find himself in a difficult predicament in cases where the property is of a kind not easily replaced, and where he cannot therefore immediately purchase a substitute. This the statute recognizes by providing that in such a case he may "establish" a "replacement fund," an option which is however subject to regulation by the Commissioner who in fact regulated it by Article 580 of Regulations 77, already quoted. By this he re-

quires an owner who wishes to "establish" such a "fund" to get "permission" which he is to obtain by filing an application in which he declares that he will replace the property as soon as possible—the prescribed form requires a date to be fixed—and, when that has been approved, by posting a bond to secure the tax "which would be payable if no replacement fund were established." The form of the "fund" is not prescribed, and, arguendo, we may assume that entries upon the owner's books, such as the taxpayer here carried, if supported by bank deposits, or mortgages, would be permissible. For example, the regulation reads: "he may obtain permission to establish a replacement fund in his accounts in which * * * the compensation * * * shall be held." The taxpayer challenges the validity of this regulation, but it appears to us to be within the power conferred by the statute. The purpose of the privilege was to avoid forcing an owner to a hasty, perhaps an impossible, investment, but it did not give him an indefinite time. Even though his failure to find "similar property" were not due to any fault of his, there must come an end and at the end he would be taxed as though the property had been voluntarily "converted." We cannot see how the regulation could have realized this with greater freedom to the owner and yet with that minimum of security to the Treasury, which was certainly demanded; it allows the owner to keep his "fund" in whatever form he finds most convenient and profitable, and only demands of him adequate assurance of his good faith and eventual performance. We do not mean that another regulation might not have been equally lawful: the Commissioner might have secured the tax by a rigid control over the form of the "fund," or by requiring that he should con-

sent to any withdrawals. But it was his function, not ours, to decide what was on the whole the most desirable method; and the form which he did choose has survived many recensions of the statute. We have no doubt that it is valid.

[3-5] Since the taxpayer at bar did not get permission, it became entitled to the exemption only so far as it in fact "expended" the money in buying "similar property"; for the Commissioner's inaction, however negligent, was certainly not a performance of the condition, and the Commissioner could not be estopped. A taxpayer who has to deal with a sluggish and inert official is always in a trying position and has just ground for complaint; but that does not discharge him of whatever duties are lawfully imposed upon him as a condition of his privileges; and, indeed, in the case at bar the taxpayer itself was not a model of diligence and care. That the mortgages of themselves would not serve without the Commissioner's permission is plain; Congress meant to suspend the tax only when an owner, forced out of one investment, found an equivalent investment, and money lent on mortgage is not the equivalent of real property, either as to its management, as to the security which it affords, or as to the return obtained from it. We affirm the order upon the taxpayer's appeal.

[6-8] Upon the Commissioner's appeal the question is whether the sum invested in 1936 in "similar property," shall be exempted from the taxable "gain" in that year; and that in turn depends upon the meaning of the concluding words of § 112(f), 26 U.S.C.A. Int. Rev. Acts, page 858: "If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so ex-

pended." The taxpayer argues, and the Tax Court agreed, that since the sum mentioned was "expended" in buying "similar property," the "gain" which could be "recognized" must not be "in excess of" what was left of the installment of 1936—$50,000. The Commissioner replies that the exemption begins only after all those parts of the award which have been "expended" in the purchase of "similar property" have been marshaled against the "basis"; and it seems to us that this is an inescapable conclusion. Obviously, an owner who receives a single award, of which he "expends" a part in the purchase of "similar property," may not exempt any part of the "gain" by allocating against the "basis" that part which he does not so "expend," and against "gain" that which he does. To do so would defeat the whole purpose of the exemption, which, as we have said, was to exempt an owner from taxes upon increases in the value of his property which he is forced to "realize" as "gains." It is a corollary that he must do what he can to restore his position to what it was originally; and, so far as he does not, he will be regarded as content with the "realization" of the increase. If an award be made in several installments paid in the same year, the result is the same. An owner who does not "expend" the first installment in the purchase of "similar property," but does so "expend" a later one, may not marshal the first against his "basis" and assert that he had "expended" all the "gain" in the purchase of "similar property."

The distinction taken by the Tax Court was that the installments spread over different taxable years must be separately computed, because the tax for each year stands alone. Hence, all money "expended" upon "similar property" in any year, if it be a "gain," is en-

titled to the exemption; and it makes no difference that in earlier years the owner has not "expended" upon "similar property" an amount equal to the "basis" We agree of course, that the tax for every year must be separately assessed; but that does not mean that in computing the tax we may not look to what has happened in earlier years. For example, if the price of property is paid in successive yearly installments, the earlier installments are first taken to amortize the "basis," and it is only after that has been done, that any "gain" arises. § 111(d) and § 44(b) of 26 U.S.C.A.Int.Rev.Code. If the Tax Court is right, by a simple expedient an owner can exempt his "gains" up to the amount of the "basis," and yet avail himself of that amount of the award for any purpose he may wish. All he need do is to use as he wishes the first installment up to the amount of the "basis," and invest the later installments in "similar property." It seems to us to need no argument to prove that that extends the privilege beyond its purpose.

The practical difficulties in application which the taxpayer suggests, do not exist. We take as the example the situation which it puts in its reply brief: the condemnation of property whose "basis" was $35,000, for an award of $150,000, paid $50,000 in each of three years. How it asks shall the "gain" be taxed? Let us assume that no part of the first installment is invested in "similar property," but that the whole of the second installment is so invested. The owner will be taxed in the first year upon his "gain"—$15,000—and in the second year upon $35,000. All the installment for that year is "gain," and must be taxed unless exempted; and it will not all be exempted, because out of the first installment an amount equal to the "basis" was not invested in "similar

property." To allow the owner to invoke the exemption before that has been done, has, as we have shown, the effect of freeing the "gain" up to the amount of the "basis" from the condition which is the presupposition of the privilege. In the case just put, the extent to which the third installment shall be taxed will depend upon how far it is invested in "similar property"; the whole "basis" having been amortized for the purposes of exemption, no deduction will be necessary. We need hardly labor the improbability that Congress should have meant to make the exemption depend upon whether an award, payable in installments, happens to be spread over more than a single year.

It is quite true that in Wilmore S. S. Co. v. Commissioner of Internal Revenue, 78 F.2d 667, a majority of this court decided the opposite. The owner's steamer had been torpedoed in 1917; it recovered $1,750,000 of insurance money, which was about $400,000 above the "basis"; and upon the "gain" so "realized" it then paid the tax. The value of the steamer had been $2,400,000, and in 1928 the Mixed Claims Commission awarded an added $650,000, upon $312,157.20 of which the Commissioner taxed it as a "recognizable gain." The owner asserted that it had in 1928 "expended" this part of the award upon other vessels which were "similar property," and that § 112(f) protected it; but the Commissioner and a majority of the Board of Tax Appeals held that the "gain" was not exempt. In this court, however, although the Board had passed upon the point now at issue the brief of the Commissioner did not press it.[2]

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2. The only three points it contained were headed as follows:

"I. The money received under the award was not

It is true that we spoke of the Commissioner's ruling as "erroneous" in disallowing the exemption because the owner had "established" no "replacement fund," but we were making use of that ruling only as evidence that he had thought that the award of 1928 had been in fact "expended" upon the new vessels; one of the issues before us and that upon which we split. Although we cannot deny that the decision did embrace a ruling contrary to that which we are now making, we do not regard it as having the same force as though it had deliberately overruled an objection pressed upon us at the time.

Order affirmed upon the taxpayer's appeal.

Order reversed upon the Commissioner's appeal.

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received directly from the casualty in 1917 as a matter of right but came to the taxpayer as damages, which were collected by its Government and remitted to it.", "II. The casualty was complete and final in 1917 and there was no conversion of the ship into this fund in the tax year 1928.", "III. The money received from the award was not used in the manner specified by the statute and hence cannot be tax free thereunder."

APPENDIX D

Statute and Regulations Involved

Internal Revenue Code of 1939:

SEC. 112 RECOGNITION OF GAIN OR LOSS.

* * * *

(f) [As amended by Section 1 of the Act of October 31, 1951, c. 661, 65 Stat. 733]. *Involuntary conversion.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

* * * *

(3) *Conversion into money where disposition occurred after 1950.* Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) *Nonrecognition of gain.* If the taxpayer during the period specified in subparagraph (b), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the asquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion

(regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock.

* * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.112(f)-1. *Involuntary conversion where disposition of the converted property occurred after December 31, 1950—*

* * * *

(c) *Conversion into money or into dissimilar property.* (1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, * * *.

* * * * *

(9) There is no investment in property similar in character and devoted to a similar use if:

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.